MUTUALITY AND CORPORATE GOVERNANCE: THE EVOLUTION OF UK BUILDING SOCIETIES FOLLOWING DEREGULATION

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Abstract

This paper studies the effects of deregulation following the UK Building Societies Act 1986, which opened the way for competition between building societies and commercial banks and introduced a procedure for the demutualisation of a building society. It is argued that the Act brought about a rearrangement of property rights which destabilised the building society form. A wave of demutualisations followed in the 1990s. The beneficiaries of change included corporate managers whose earnings and status were enhanced following conversion, and speculative investors who profited from windfall gains. These were set against losses to borrowers, in the form of higher costs of loans, and to communities, in the form of reduced diversity of services. There is no guarantee that the recent trajectory of the sector is one of 'evolution to efficiency'. Rather, its experience illustrates the often unexpected consequences for corporate governance of changes in regulation and property rights.

JEL codes: K22, L31.

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1. Introduction

This paper studies the effects of deregulation of the UK building society sector following the Building Societies Act 1986. The traditional, pre-1986 building society form contained within it several institutional features which were designed to minimise what Hansmann (1996) refers to as internal 'governance costs'. These included strict limitation of corporate objects (the 'straightjacket'), the practice of one-member, one vote, and the persistence of complex rules for winding up a society or transferring its business. The effect was to minimise internal divergencies of interest and to lock away the surplus or residual from the organisation's activities in such a way as to preclude predatory strategies for gaining access to it by a particular generation of members. In the process, most building societies acted in a manner akin to what Hansmann (1996) refers to as 'non-profits', that is, entities without owners.

The Building Societies Act 1986 opened the way for competition between building societies and commercial banks and at the same time introduced a procedure for 'demutualisation', that is to say, the conversion of a building society into an investor-owned commercial company. By allowing conversion, the Act made it possible for the residual to be unlocked and distributed to the current generation of members. This undermined the basis for the principle of 'identity of interest' between lenders and borrowers on which corporate governance in building societies had previously rested. As a result, by the mid-1990s a wave of demutualisations had begun, spurred on by a combination of managerial initiative and campaigns led by 'carpetbaggers' intent on gaining a windfall profit for their initial investment once conversion went ahead. In a minority of societies, management responded by building new defences against predation, in the form of charitable assignments and other poison-pill like devices aimed at locking away the residual once more. However, the future of the mutual form in this sector is currently in some doubt.

Two interpretations of the evolution of the building society sector after deregulation are possible. According to one, the move towards demutualisation reflected the replacement of an archaic and decaying business form (the financial mutual) by a more modern and efficient one (the shareholder-owned company). The 1986 Act was the catalyst for change which had been unduly delayed by the over-rigid regulatory framework which it replaced. This account stresses evolution to efficiency at the level of the institutional framework. A second interpretation is that demutualisation signifies the loss of an inherently efficient form for the delivery of long-term, low risk savings contracts and loan contracts. The change in the regulatory framework which occurred in the mid-1980s was not neutral; it removed the basis on which conflicts of interest between investor and borrower members had previously been managed, creating an institutional hybrid which was inherently unstable. The main beneficiaries of change were corporate managers who used conversion to boost their earnings and status and 'carpetbaggers' who profited from windfall gains. These groups were a better position to organise for conversion than the main losers from demutualisation, the borrowers, were to resist it. Accordingly, a path-dependent explanation which stresses the role played by institutional lock-in in producing sub-optimal outcomes is called for.

These competing claims will be examined as follows. Section 2 below outlines a theoretical explanation for the emergence of financial mutuals which draws on the 'new institutional' analysis of Hansmann (1996). Section 3 examines in more detail the recent history of the UK building society sector and considers how far its experience bears out Hansmann's hypotheses concerning the efficiency properties of the mutual and non-profit forms. Section 4 evaluates the process of change and considers the case for legislative reform aimed at stabilising the sector. Section 5 concludes.

2. The corporate governance properties of financial mutuals and non-profits

Henry Hansmann's seminal analysis in *The Ownership of Enterprise* (1996) demonstrates the diversity of corporate governance arrangements available for the legal organisation of the enterprise. Different types of enterprise are characterised by different arrangements of property rights, income streams, and regulation. At the heart of Hansmann's analysis is a theory of ownership. Ownership has two dimensions: residual control rights of the kind emphasised by the property rights theory of the firm (Hart, 1995) and residual income rights of the kind stressed by the nexus of contracts approach (Fama and Jensen, 1982; Easterbrook and Fischel, 1991). Hansmann argues that residual control rights and income rights tend to go together because 'if those with control had no claim on the firm's residual earnings, they would have little incentive to use their control to maximise those earnings, or perhaps even to pay out the earnings received'. This would not be a problem in a world of complete contracting. But where contracts are ex ante incomplete - which is almost invariably the case in complex arrangements of corporate governance involving inputs from multiple stakeholders (see Zingales, 1998) - separation of control and income rights threatens to give rise to insurmountable contracting costs. This problem is avoided by allocating residual rights to the group with the strongest incentive for resolving, ex post, the conflicts which will inevitably arise: 'the essence of what we term "control" is precisely the authority to determine those aspects of firm policy that, because of high transaction costs or imperfect foresight, cannot be specified ex ante in a contract but rather must be left to the discretion of those to whom authority is granted' (Hansmann, 1996: 12).

The various corporate governance forms solve this problem in different ways:

> 'in an investor-owned firm, the transactions between the firm and the patrons [or stakeholders][1] who supply the firm with capital

occur in the context of ownership, while transactions with workers, other suppliers, and customers all take the form of market contracting. An employee-owned firm, in contrast, obtains labour inputs from workers whose relationship is one of ownership, but obtains its capital and other supplies, and sells its products, through market contracting. And a consumer cooperative, in turn, obtains capital, labour, and all other inputs through market contracting while selling the goods and services it produces in transactions embedded in ownership' (Hansmann, 1996: 20)

The result is the multiplicity of forms observed in practice (see Table 1).

Table 1: Economic organisations characterised by corporate governance structures

Producer-owned	Customer-owned	Investor-owned
Professional partnerships (law firms, accountancy firms, etc.) Employee and producer cooperatives	Mutuals (retail cooperatives, friendly societies, industrial and provident societies, credit unions, mutual insurers, building societies)	Shareholder-owned companies (listed companies, private companies or 'quasi partnerships')

According to Hansmann, particular ownership structures emerge as an efficient response to the need to reduce the sum total of 'governance' (or transaction) costs, which he classifies in terms of (1) contracting costs and (2) ownership costs.

Contracting costs are essentially the costs of contracting in a decentralised market setting, such as monopoly, ex-post lock in, high risks of opportunism in very long term contracting, asymmetric information, and other forms of strategic behaviour. Where such costs are excessively high, efficiency requires that stakeholder groups with most to lose from market transacting should seek to 'internalise' the transaction through ownership. For example, the risks of fluctuations in market conditions over the life of a very long term contract can be minimised by combining ownership with custom; in the case of mutual assurance companies, what the members might lose as customers they would gain as owners.

The costs of ownership are, conversely, the costs of integrating assets into a single entity. These include the familiar kind of agency costs which arise from the separation of control and ownership in large, publicly-held companies, but also the costs of collective decision making which arise when preferences of stakeholders are highly heterogeneous. Active participation in governance also carries with it high costs in terms of time and effort. In addition, ownership creates costs as a result of the uneven distribution of risks: identifying a set of residual claimants may be highly costly if that group is not in a position to diversify its risk in some way.

Applying Hansmann's calculus, we arrive at the suggestion that efficient corporate governance forms are those which minimise the sum total of (1) (external) contracting costs and (2) (internal) governance costs. The contracting costs criterion suggests allocating rights to that group of stakeholders whose inputs cannot be effectively contracted for externally. The governance costs criterion assigns ownership to that group which can most effectively undertake the role of governance in the interests of the firm. A highly significant implication of this analysis is that the two criteria may point in opposite directions, or at least may be in tension with one another. On the basis that more efficient forms will, over time, display greater stability and survival value than those which are inefficient, Hansmann makes the following predictions:

1. ownership is very rarely shared across different stakeholder groups, because of the high collective action costs which would arise from heterogeneous interests;

2. where high external contracting costs and low internal governance costs point to the *same* group being the most efficient owners, forms based on this outcome will generally prevail over rivals;

3. where contracting costs and governance costs point in *different* directions, it may be efficient to grant ownership to passive owners who at least have the assurance that no other stakeholder group can claim ownership;

4. alternatively, the efficient solution may be to assign control to no single group, as in the case of the non-profit firm.

Of particular interest for present purposes is Hansmann's suggestion that financial mutuals, such as building societies or (in the US context) mutual savings and loans associations, have many of the features of non-profits such as private-sector health care providers, universities, and charities. Customer ownership of financial institutions such as banks and insurance companies was established early in the nineteenth century, he suggests, as a way of dealing with the problem of managerial opportunism and asymmetric information; most investor-owned banks engaged in speculative (high risk, high return) ventures which put savings of investors at risk. One solution in the US context was provided by mutual savings banks which were set up to attract long-term savings from depositors but also donations from wealthy philanthropists; the directors held the assets on trust for depositors with the latter having no voting rights. This is a characteristic example of a non-profit, in which it is impossible to release residual profits in cash form for any one of the various stakeholder groups; at best, the residual is released to the members in the form of improved services, or is reinvested.

By contrast, early building societies (or in the US, savings and loans) were true mutuals which were customer-owned; depositors obtained voting rights, on the basis of one person, one vote (although *not* one share, one vote, as in the case of shareholder-owned companies), and rights over the residual income. The 'non-permanent' building society which wound itself up after all the members had purchased a property had the advantage of overcoming asymmetric information problems about credit risks, since the members were all known to each other or came from the same locality. The traditional credit union with its 'common bond' (the requirement of membership of a particular community or employment) operated in the same way.

With the later emergence of the 'permanent' building society or mutual savings and loan association, successive and overlapping generations of borrowers entered the picture, and societies began to distinguish between borrowers and depositors. According to Hansmann, this eliminated some of the advantage which mutual forms had had over investor-owned banks; as a result, they became more like traditional mutual savings banks, in which members were generally passive, and self-perpetuating boards operated as fiduciaries for the depositors.

From this point on, competition between mutual and investor-owned forms was decisively influenced, in Hansmann's analysis, by government regulation. Government regulation of investor-owned banks, which took the form of minimum capital requirements, maintenance of minimum-level liquid reserves, and limitations on investments that could be included in bank portfolios, removed some of the risks for depositors of commercial bank lending. In the aftermath of the Great Depression, mandatory deposit insurance was imposed on all banks (whether investor-owned or mutual), thereby removing still further the advantage of mutuals. For a time, regulation continued to favour mutuals on tax grounds and through regulation of interest rates on deposits. This was done on the basis that mutuals were safer from the point of view of government as insurer of last resort, although this preference did not take the form, as it might have done, of charging a lower insurance premium to mutuals. By the 1980s, preferential regulation of mutuals had been removed and bank deregulation meant that restrictions on investment portfolios no longer existed; it also became possible to transform mutuals into investor-owned banks. The subsequent unhappy history of the savings and loans sector then unfolded: a large number of converted savings and loans associations became insolvent as a result of high-risk loan activities, engendered in large part by the moral hazard implicit in the government's willingness to underwrite their activities through deposit insurance at the same time as liberalising the restrictions which had previously been imposed on lending.

According to Hansmann, the conversion of US savings and loans from mutual to investor-owned companies in the 1980s occurred at a point when 'investor owned banks were giving evidence of being less efficient, overall, than their mutual counterparts' (Hansmann, 1996: 258). Mutuals, he suggests, were less effective at controlling costs than investor-owned banks, but their much lower failure rate more than offset this. On the other hand, investor-owned banks had more ready access to equity capital and thus were able to respond more effectively to shifts in consumer demand and to the possibilities created by new technology. His analysis thus leaves open the issue of how we should regard the evolutionary processes at work in the US case. Was the demise of the mutual savings and loan sector the inadvertent result of regulatory failure, or were more fundamental economic forces at work in the unravelling of the mutual form? To help answer this question, we will now look in more detail at the British experience which is in some respects similar to that of the US but also has several distinctive features.

3. Deregulation and demutualisation in the British building society sector

3.1 The origins of the building society movement

In Britain building societies grew out of the friendly society movement of the 18th century. Their emergence was linked to the industrial revolution and the need for housing for workers moving to cities and experiencing very poor living conditions. Members would agree to contribute regularly to the society, build houses together, and allocate houses by lottery until each member was housed. As this model was widely adopted, building societies became responsible for the supply of a substantial proportion of the total housing stock in the UK (Morgan, 1995).

The first legislation covering friendly societies was enacted in 1793 and the first Act covering building societies was enacted in 1836, 60 years after the emergence of the first building society (Ketley's Building Society of Birmingham, founded in 1775). As we have noted, the first building societies had a limited lifespan, related to the specific objective of providing housing for a defined group of members. Once this had been accomplished and the money had been repaid, surplus assets, if any, would be distributed equally among members and the society would be terminated. There were nevertheless problems associated with the terminating society system, particularly in relation to a lack of funds to afford construction of enough houses. The first Building Societies Act attempted to address these problems and, in so doing, encouraged the appearance of permanent societies (the first was founded in 1845) in which funds for building houses were supplemented by funds from people wanting to save, but not necessarily wanting a house. As Hird (1996) argues, this development loosened the bond which had previously existed between savers and borrowers. However, the 'permanent' form had the advantage of widening the investor base and offering a stable and relatively risk-free form of saving, while also successfully managing the inherent conflict of interest between the two groups for over a century.

Permanent societies proved to be highly effective; they were able to borrow money from investors to build houses more quickly, create different classes of shares, and set up reserve funds (Clarke, 1998).

By 1900 there were 2,286 permanent and terminating societies across the UK. Up to 1950, individual building societies remained comparatively small, collectively holding only 10% of retail savings. Although their share of the mortgage market was significant, the market itself had remained relatively small, with owner-occupation only accounting for around 25% of households by 1950 (Boleat, 1987). Medium and large-sized building societies emerged due in part to organic growth and also to a large number of takeovers and acquisitions in this sector, resulting in a substantial decrease in the overall number of building societies, from over 2,200 in 1900, to 481 in 1970, and 130 in 1988, prior to the demutualisation wave (Wells, 1989; Barnes and Ward, 1999).

The period of greatest growth in the building society movement was between 1955 and 1980. During the period there was limited competition from other financial institutions for lending for house purchase and limited competition within the building society movement itself as a result of rate cartels. Building societies in effect had an oligopoly with banks in the retail deposits market. In addition, over this period there was a decline in private sector rented accommodation as a result of rent controls, tax advantages for owner occupiers, and limits on public-sector spending on housing. Owner-occupation increased to 50% of all dwellings in 1970, and then to 65% in 1988, partially as a result of council house sales beginning in the late 1970s. Then, following the stock market crash of 1987, building societies experienced a flood of funds into the sector, looking for secure forms of saving (Graham, 1984; Barnes and Ward, 1999). Altogether, over the 150 years up to the mid-1990s building societies are reported to have built up £16bn of reserves (Davidmann, 1996).

3.2 The property rights of building society members in the 'traditional' mutual (pre-1986)

The growth of the building societies, while assisted by the competitive and regulatory factors just referred to, was also engendered by the success of the particular legal form given to permanent societies, and to the type of corporate governance which it gave rise to. Building society legislation, up to the deregulating measures of the 1980s, severely confined the permissible objects of building societies and imposed other restraints on building society constitutions. As the Building Societies Association (BSA) noted in 1983,

> 'the building society is a special legal creature. It derives its powers primarily from the Building Societies Act 1962. Like other "creatures of statute", for example local authorities…, building societies can do only those things and can operate only in the manner which is envisaged by legislation. They are therefore unlike most normal corporate bodies which are free to decide their functions and method of operation within the general law of the land' (BSA, 1983: 5).

Similarly, a leading legal authority described the regime inherited from the nineteenth century in the following terms:

> 'it is necessary to understand that [building societies] are special statutory creatures, in a statutory straight-jacket, and that unlike individuals, partnerships or companies in this respect, they have no choice in the matter of the business which they carry on' (Wurtzburg and Mills, 1976: 3).

In this vein, Thompson (1995) refers to the property rights of building society members in the traditional model as 'severely attenuated' by comparison to those of shareholders in commercial companies. The following features, in particular account for this attenuation.

(1)Restricted objects. As Thompson notes, building societies began as specialised financial intermediaries, providing housing finance for persons of comparatively modest means, and, notwithstanding the deregulatory provisions of the 1980s, have continued to focus on the provision of financial services in connection with housing. The 1962 Act, consolidating the nineteenth century legislation, stated that a building society could be established for the *sole* purpose of 'raising, by the subscription of the members, a stock or fund for making advances to members out of the funds of the society upon security by way of mortgage of freehold or leasehold estate'. This limitation of objects encapsulated the ownership structure of the traditional building society: *the near-complete correspondence between its owners and its customers*. A society was not allowed to advance loans to persons other than its members, and it was the members' own subscriptions, in turn, which were intended to be the principal source of funds. As the BSA (1983: 5) put it,

> 'Section 1(1) and subsequent sections of the [1962] Act mean effectively that building societies are owned by their customers rather than by equity shareholders. As such, societies are frequently referred to as being mutual although this term is difficult to define and is not used in building society legislation. Societies raise most of their funds through share investments but the point is that membership is incidental to investing. Moreover, borrowers have to become members or they are not able to borrow'.

When commercial banks started moving into the mortgage market in the early 1980s, building societies pushed for legislative changes that would allow them to move into areas of service provision previously only offered by banks. The 1986 Act altered the position slightly by stipulating that the *principal* (no longer sole) purpose of a building society was to be the raising of funds for advances to its own members. This, it was said, 'may have loosened the statutory straight-jacket; but it has not discarded it'.[2] The other, subsidiary purposes allowed to building societies were still those defined by the Act. These empowered building societies to extend their services into areas such as personal loans and current account provision, in competition with commercial banks (see Wells, 1989). In addition, the Act formally gave building societies the ability to borrow on wholesale markets up to 20% of their total deposits (most societies had previously had this right under their constitutions but the Act regularised the position). This was extended to 40% and then 50% by 1997. In some areas building societies began to offer more customer-attractive services, such as free banking and interest-paying current accounts, which placed pressure on banks to focus to a greater extent on customer service (Gentle et al., 1991: Davidmann, 1996). However, certain limitations on building societies' activities remained. Under the 1997 Act, at least 75% of business assets still had to be held in mortgages and at least 50% of funds had to come from members who are individuals. In practice, societies continue to remain well within these boundaries.[3]

The Act of 1997 made a further change by allowing a building society to choose its own subsidiary purposes by reference to its memorandum of association.[4] Moreover, although the principal purpose must be 'that of making loans which are secured on residential property and are funded substantially by its members',[5] the reference to the members being the main source of the fund was removed. The implication of this change was building societies could now engage in a wider range of commercial activities. However, since the principal purpose of a society remained the making of loans to members, it could be said that the benefits of the society's wider activities were still intended to accrue to the members (in the form of cheaper loans, for example, in the case of borrowers, or higher savings rates in the case of investors).

(2) Dispersal of internal control rights. The traditional rule within building societies has been one member, one vote. In the words of the BSA (1983: 5), 'voting power in a building society is not normally weighted according to the value of shares held and it follows that except in the smallest societies it is impossible for even a substantial number of members to have sufficient votes to enable them to exercise control over the society'. This means, as Thompson puts it (1995: 345), that the separation of ownership and control is 'particularly acute'. Members have little incentive to become active in internal governance issues because of the difficulty of putting together coalitions of voters, and the tendency of individuals to free ride on the action of others in attempting to do so. On the other hand, the possibility that incumbent managers would be free from scrutiny for this reason is constrained in practice by a number of factors including the regulatory controls exercised by the Building Societies Commission, the need for managements to build up reserves to fund any expansion (in the absence of any external equity capital) and the possibility of low-cost exit by investors, who are generally able to move their funds out of societies on very short notice.

(3) Limited residual risks of members. Investor-members of a building society, who can normally withdraw their funds at any time, are not in the same position as shareholders in a public company, whose investments are in a sense irreversible: they can only recover them if the company succeeds and they can sell their shares on the open market for at least the amount they paid for them. The essence of the traditional property right, then, was that building society members were exposed to limited risk. As the BSA put it in 1983, with regard to investors:

> 'the shareholder in a building society is in a very different position from the shareholder in a limited company… the purchase of shares in a limited company is speculative and involves high transaction costs. It is possible to make a capital gain or to lose a part, if not all, of the investment. By contrast the attractions of investment in building societies are that there is, in practice, no chance of a loss or gain in capital value (indeed, the Association operates a scheme to protect share investors), and that the investment is readily withdrawable. As far as most people are concerned being a shareholder in a building society is analogous to being a depositor in a bank rather than a shareholder in a limited company' (BSA, 1983: 6).

(4) Limited residual claims. The traditional logic was that just as building society members had limited risks, so they also had limited claims to the residual income of the society. Thompson (1995: 344) suggests that the owner members, nevertheless, 'have the right to approve a change in ownership of the entire society and may receive payment in compensation for any ownership claims thereby lost'. This statement is true in the sense that, upon a winding up of a society, any surplus would indeed revert to its members, under general principles of law.

However, prior to the 1986 Act, the only occasion on which a society would be wound up or dissolved was, in practice, when it failed and had to be merged with another, more successful society. A voluntary winding up was possible under statute if three quarters of the members, holding between them not less than two thirds of the shares, signed an instrument of dissolution – a formidably high barrier. Even then, the procedure set out in the Act was long and complex. Alternatively, winding up could occur following a special resolution (three quarters majority) at an extraordinary general meeting, but even then only under the supervision of the court. Building societies could make their own, separate provision for a more straightforward winding up, but it would not have been in the interests of most the managements of most societies to take up this option. The residual ownership rights of members were, therefore, more or less completely theoretical at this stage.

This incentive structure was, arguably, a highly efficient way of providing a low-risk, long-term borrowing arrangement for the principal users of building society services, namely, those with limited means of their own. Borrowers were safeguarded against the risks of any failure by the society in the decades-long loan contract by a number of features of building society constitutions: the classes of investors and borrowers were, effectively, the same, thereby establishing a strong homogeneity of interests, and the possibilities for speculative gain were virtually non-existent thanks to the restrictions on building society objects and the dispersal of voting power, in addition to the effects of regulation.

3.3 The process of demutualisation

The crucial change made by the 1986 Act was not the modest extension of building society powers, but the provision for demutualisation. Up to this point only agreed mergers among building societies had been allowed. This change was established in line with the intention of giving societies greater freedom to diversify into a wider range of financial services if they so wished, and in line with a broader programme of deregulation. At the time, it was generally expected that '[not] more than a handful of building societies, if any, [would] attempt this course of action' (Boleat, 1987: 34; see also Hird, 1996). As events turned out, the most distinctive feature of the building societies sector over the past 15 years has been the demutualisation phenomenon.

The Abbey National Building Society was the first to demutualise in 1989. At the time it was the second-largest building society. In 1995 the Cheltenham & Gloucester Building Society converted into a commercial bank and was simultaneously taken over by the Lloyds Bank Group. In 1996 Abbey National took over National & Provincial Building Society. In 1997 there was a spate of demutualisations. Alliance & Leicester Building Society, Halifax Building Society (the largest building society - having merged with Leeds Permanent in 1995), Woolwich Building Society, Northern Rock Building Society and Bristol & West Building Society (acquired by the Bank of Ireland) all converted into commercial banks.

Up to that point, conversions had all taken place with the support of the boards of the building societies; the main instigators of change had been building society managers themselves. However, in April 1999 members of the Bradford & Bingley, the second largest of the remaining building societies, voted to convert into a bank, this time, against the board's advice and at the instigation of so-called 'carpetbaggers', short-term investors whose sole motivation was to press for conversion in order to make a windfall gain from their membership. Speculative investing and carpetbagging were suddenly seen to threaten a number of remaining building societies. Members of the Nationwide (the largest remaining building society) and the

Britannia Building Societies, voted against demutualisation proposals.[6] However, demutualisation efforts continued in the cases of the Chelsea, Skipton and Portman Building Societies (Snowdon, 2000). Of the conversions occurring since 1995, seven of these were among the largest 10 building societies and these conversions (not including Bradford & Bingley) effectively transferred two-thirds of the total assets held by building societies in 1994 out of the sector.[7]

The remaining building societies went on to develop a wide array of defences against carpetbaggers. The most frequently used is the 'charitable assignment', under which new members were required to sign away potential windfall gains to charity. Legislation (the Building Societies Act 1997) altered the turnout and voting outcome levels required for boards to be forced to accept a proposal and allowed building societies to raise the number of members required to support an AGM resolution in order to have it put on the agenda. In some cases, management took an aggressive line against demutualisation proposals, declaring demutualisation proposals invalid under the terms of articles of association and suspending the membership of suspected 'carpetbaggers' (Gow, 2000; Foley, 2000a).

3.4 Property rights of building society members post-1986

The significance of the 1986 Act for demutualisation lies in the way in which it altered the nature of property rights and so shifted the basis on which internal corporate governance was conducted. The effect of the 1986 Act (as interpreted in the courts) was that coalitions could now be put together in favour of demutualisation because of the possibility that even short-term owners would receive a share of the society's assets upon its change of status. Other changes undermined the close identity of interest between investors and borrowers, and so enhanced incentives for conversion.

Section 97 of the 1986 Act made it possible for a building society to transfer its business to a commercial company, thereby avoiding completely the statutory restriction on its legitimate purposes, if a particular procedure was followed. Where the transfer was made to a new company set up for the purpose of inheriting the society's business, two resolutions of the members were required: firstly, a simple majority of the borrowing members; and, secondly, a three quarters majority of all the shareholders (the investing members), with at least 20% of all those eligible to vote doing so. These rules were designed to set a high threshold.

In addition, section 100(8) of the Act made the following provision:

> 'Where, in connection with any transfer, rights are to be conferred on members of the society to acquire shares in priority to other subscribers, the right shall be restricted to those of its members who held shares in the society throughout the period of two years [prior to the transfer]'.

The prevailing legal opinion at the time of the Act's enactment was that this measure was intended to deter opportunistic entry:

> 'The purpose of these restrictions… is to minimise the risk of a sudden flow of investment into a particular society… because of a rumour that that society is about to transfer its business to a company and there might be substantial bonuses for members. Under these provisions, only a limited class of members will receive such bonuses. The restriction should also help to allay fears that the directors of a society may in effect bribe members to vote for a transfer by the promise of substantial bonuses'.[8]

The failure of section 100(8) to deter opportunistic entry in the years following its passage was the consequence of a number of inter-related factors.

Firstly, the protection offered by section 100(8) turned out to be more apparent than real. The subsection came before the courts in a test case brought by the Abbey National Building Society prior to its conversion to a commercial company in 1989.[9] The Society intended to grant all members of the society on the relevant date, and not simply those who had been members for two years, so-called 'free shares' in the new, listed company. This would enable those allotted the shares to make an immediate windfall gain if they chose to sell them following the company's listing. A number of arguments were put before the court to the effect that this did not, nevertheless, contravene section 100(8). The Society argued that the members who received shares would not do so 'in priority to other subscribers'. The judge, Sir Richard Scott VC, took the view that the point in question was 'very obscure'. He concluded that what was intended was 'a provision which prevented the members, other than two year members, obtaining for themselves some form of priority by way of shareholding in the successor company'.

However, he went on to hold that the subsection was not infringed if the non two-year members were given rights in priority over members of the general public; it was only if these members were given priority rights over others who, in *the transfer document itself*, were given rights to subscribe for shares in the new company, that the Act was infringed. The effect of this ruling was that it became possible for gains to be made by members of the society who had joined within the two year period, notwithstanding the apparent aim of the Act.

Secondly, building societies traditionally operated an open-door policy with regard to investor-members. The effect, as Thompson (1995: 345) puts it, was that any property right of the existing members was non-exclusive. This was not a problem during the period when the members were, in any event, not in a position to profit from the residual income of the society, except in their capacity as users of the society's services. However, the ease with which entry could be accomplished mattered greatly once the 1986 Act opened up the surplus to distribution.

It has been said that the government's thinking in relation to this part of the 1986 Act was that since building societies were mutuals and, as such, 'owned' by their members, it was appropriate for legislation to make it possible for them to vote to change the society's status, subject to the safeguards which we have just been examining.[10] The argument from ownership was more novel than it seemed. As we have seen, although the owners did have certain residual ownership rights prior to 1986, these were exceptionally weak. The reasons for this were, moreover, justifiable from the point of view of providing an efficient incentive structure for the management of risk over the long-term: the members, both savers and borrowers, had minimal risks, in return for minimal income rights.

Whereas, prior to the Act, the members had very restricted rights, if any, to the residual surplus built up by a society, after 1986 it became possible for all members to gain access to it by means of a demutualisation. A demutualisation would release assets by making it possible for payments to be made to members not just in the form of cash distributions, but also through 'free shares' in the new listed company. Although high voting thresholds were set for the change of status to proceed, the possibility of realising part of the surplus in this way in effect drove a wedge between borrowers and investors: investors, particularly those who had purchased their shares for the sole purpose of voting for demutualisation, now had a directly opposing interest to those of the borrowers. The potential for divergence was then heightened by the court ruling in effect nullifying the intention of section 100(8) of the 1986 Act.

3.5 Hostile takeover bids for building societies

The most common form of hostile takeover for a publicly-listed company, a 'tender offer' in which the bidder offers to buy shares held by the target's shareholders at (normally) a premium over the existing market price, is inapplicable to a building society, since the members' shares are not alienable in this way. However, the 1986 Act opened up an indirect route for a hostile takeover by, as we have seen, allowing building societies to convert to commercial company status. This made it possible for a bidder to approach the members with the aim of encouraging them to put forward a resolution for conversion, to be voted on at an extraordinary general meeting. If the board of the target resisted, the members could be encouraged to vote the directors out of office. By this means – what in US terminology would be called a 'proxy fight' for control – the members would acquire shares in a commercial company which could then be purchased by the bidder. This route was adopted in a hostile bid which was mounted, unsuccessfully as it turned out, for the Leek Building Society in 1997 and a similar type of bid was mounted for control of the Chelsea Building Society in April 2000.

The procedure for putting together a hostile bid for a building society is potentially highly complex, even by comparison to the devices which must be deployed in the case of a bid for a listed company. Bids for control of companies listed on the London stock exchange are subject to the jurisdiction of the City Panel on Takeovers and Mergers. The City Code imposes a bid timetable and imposes a number of obligations upon both bidders and targets which are designed, on the whole, to protect minority shareholders in the target from oppression or abuse. The overall impact of the City Code, in conjunction with a number of rules of company law and institutional shareholder practice, is very considerably to limit the degree to which target boards can frustrate bids either in advance or while a tender offer is being considered. In particular, targets boards must offer disinterested advice to shareholders on the merits of the price which has been offered for their shares. It has been argued that these specific obligations under the Code do not fit together well with the general duty of the board to act in the good faith in the interests of the company's members: the Code directs the board to consider the short-term interests of the shareholders, whereas the general company law duty allows them to take a longer-term view (Deakin and Slinger, 1997).

The Building Society Commission's *Transfer Procedures Guidance Note* of April 1998[11] offered the following prudential guidance in relation to hostile bids:

> 'It is for the board of a society to decide whether to recommend a takeover to its members. The overriding duty of the board is to reach a view having regard to what is in the interests of the members as a whole, both present and future, borrowing members as well as shareholders…
>
> The decision of the board to recommend a takeover must be based on a proper evaluation of the issues in relation to a strategic assessment of how the society can best serve its members'

The Building Society (Transfer of Business) Regulations 1998 also placed boards of societies under a number of more specific duties in regard to the conduct of the transfer of a society's business to a commercial company. In particular, the board must provide an objective, factual statement of the options for the future conduct of the society's business, and must give reasons for any recommendation by the board in support of the transfer.

It is arguable that the current regulatory framework of building society transfers gives boards of societies greater autonomy to take into account a wide range of interests which would be affected by a hostile takeover, than is the case with listed companies. The reference in the 1998 Regulations to the divergent interests of borrowing and investing members is a recognition that building societies are in a distinctive position in this regard. Likewise, the reference in the Guidance Note to the interests of present *and future* members is a potentially important clarification of the content of the directors' fiduciary duties. This clarification runs strongly counter to the short-term orientation which characterises the City Code in the case of listed company takeovers.

However, notwithstanding these provisions, the board may have only limited room to manoeuvre if it is faced with strong pressure from members for a vote on demutualisation. Under building societies legislation, the number of members needed to requisition a special meeting under the rules of a society may not exceed 100.[12] The precise division of responsibility between the board and the members, and the circumstances under which a board must respond to an instruction from members to initiate a transfer, are not completely clear in the present state of the law. It is therefore open to a potential bidder to encourage the members to take steps which, either in law or in practice, will oblige a board to put the matter of a transfer to a vote of the members under the procedure laid down in the 1986 Act.

In short, the effect of the 1986 Act, in making demutualisation possible, was far reaching. The close relationship between property rights, governance structures and objects which had characterised the traditional building society model was undermined, in favour of what was essentially a hybrid model. This hybrid shared some features of the traditional mutual, in which the residual from the society's business was effectively locked up, for transfer to future generations, with a commercial company model in which that residual could be realised for short-term gains by the present members. In the process, the traditional autonomy of building society boards was called into question. In particular, the possibility of a hostile takeover being mounted through the route of an internal 'proxy fight' was increased by legislative changes which made it easier for members to requisition a special meeting at which the views of the members on demutualisation might be sought. It is against this background that the demutualisation wave of the late 1990s took place.

4. Evaluating the demutualisation process

We now turn to an evaluation of the demutualisation process. We firstly identify the extent to which demutualisation decisions appear to have turned on the private incentives of managers and speculators. We then examine the impact of conversion on borrowers and on local communities served by building societies. Finally we assess the efficiency case for and against the preservation of building societies, drawing on what is known from empirical studies of the properties of this type of financial mutual.

4.1 Private incentives: managers and carpetbaggers

A senior manager of the Halifax noted some time before the demutualisation of this building society that ‘all arguments for conversion are fairly arcane as far as our members are concerned. The single argument that will convince them is the release-of-value argument.’[13] Prior to the demutualisation decisions of the large building societies in the mid-1990s, speculative flows of money to building societies had followed indications of their likely demutualisation, spurred by the promise of cash and/or share distributions (Davidmann, 1996). Subsequently, ‘carpetbaggers’ opened accounts specifically to promote conversion in a particular society, or in a number of societies.[14]

As we have seen, the legislative requirements on voter turnout and voting support required for investors were set at higher thresholds than those for borrowers. In the case of investors, turnout and support requirements were 50% and 75% respectively, while in the case of borrowers there was no turnout requirement and only support by a majority vote was required for a conversion resolution to pass. Although the high thresholds set for investor members were intended to provide protection for the borrowers, in practice they may also have made it more likely that investors would vote, so tilting the outcome in favour of conversion. Voting outcomes for conversion decisions consistently demonstrated greater support for conversion among investors than among borrowers. In the case of Bradford & Bingley demutualisation, although overall the vote was in favour of conversion (62%), 60% of borrowers who took part voted in favour of the society remaining mutual. The result did not pass the statutory hurdle for conversion decision to go ahead; it was the board which took the decision to initiate conversion proceedings on the basis of the result.[15] This support was won on the basis of projected average payouts of £2,000. The actual average payout, decided at the time of B&B’s floatation last December, turned out to be somewhat lower at 250 shares per member, worth only £610 at the end of the first day's trading.[16]

Managerial motives for demutualisation also appear to have played a significant role. Davidmann (1996) identifies the following potential factors: pay increases associated with executive management of investor-owned companies as opposed to building societies; the concern of senior executives and directors to maintain their position in the converted business; the desire for increased size and growth of the business over more directly member value-enhancing performance improvements, where pay is typically linked to deposits, turnover, and surplus (profit) generated; and the degree of protection from hostile takeovers that size offers (see also Howcroft, 1999; Barnes and Ward, 1999).

There are several instances of the conversion process itself providing a significant short-term source of gain for senior managers. For example, at the time of the decision by Cheltenham & Goucester Building Society to be taken over by Lloyds, the chief executive stood to benefit from share options worth four times his basic salary, and he and his immediate family were to be granted £37,600 in cash bonuses. The Chairman and his immediate family stood to receive cash bonuses of £55,000 and eight other executives were to receive share options (Davidmann, 1996).

The conversion process also had implications for managerial entrenchment. Under the 1986 Act, conversion offered boards protection from hostile takeover for a period of five years from the date of demutualisation. For mid-size societies such as Northern Rock and Alliance & Leicester in particular, conversion may have been seen as a means of avoiding a contested takeover (Marshall et al., 1997; Gilmore, 1997).

The strong private incentives of managers, in some societies, and ‘carpetbaggers’ in favour of conversion are not in doubt. This in itself does not imply that conversion was inefficient. Individual self-interest could be the driver of a change which results in overall efficiency gains, as it is often claimed to be for hostile takeovers and other mechanisms of restructuring in the case of shareholder-owned companies. But what of the impact of conversion on customers and communities?

4.2 Consumer welfare considerations: the effects of demutualisation on borrowers and communities

In contrast to the immediate gains to managers and speculative investors, there is substantial evidence that demutualisation harms the interests of borrowers in all but the very short term. The windfall gains to building society borrowers, in common with investors, might enjoy as a result of demutualisation, have been calculated to fall short of the overall increases in the margins between interest charged on mortgages and interest earned on savings: 'the typical period after which demutualisation would be seen to be a disadvantage was four years for a mortgage payer.' [17] It is only for a 'carpetbagger' investing the minimum £100, as has been the strategy of many speculators to gain membership, that the gains would clearly outweigh the losses.

Building societies are able to offer cheaper loans to borrowers because they enjoy an important cost efficiency in not having to service external capital (Brown-Hume, 1999b). Building societies are not expected to pay dividends to shareholders, as listed companies are. In principle, this results in a lower cost of capital and therefore a greater surplus to be devoted to the running of the business. This means that building societies can either build up reserves or sustain a smaller differential between the interest paid on investments and the interest rate charged on mortgages than a bank with similar operating costs.

The evidence on the interest margin between savings and mortgages for building societies compares favourably with that for banks and lends support to this proposition. The ninth edition of the annual KPMG survey of building societies' financial performance, published in September 1999, shows that the average industry net interest margin for building societies was 1.55%, which was 0.5% lower than that of the large commercial lenders. In order to sustain narrower margins building societies were showing reduced profits, resulting in a 'modest' reduction in the industry's average capital strength: average gross capital fell from 8.4% to 8.29% (KPMG, 1999). Results from a study published in 1997 by SBC Warburg Dillon Reed, investigating the sustainability of this pricing strategy, found that four of the largest building societies could sustain their pricing strategy indefinitely, with the remainder being able to sustain their pricing strategies for between nine and thirty-four years.[18]

While not all investor-owned companies pay dividends and some building societies do pay profit-related bonuses to their members, in the case of building societies, all redistributed profits (in the form of higher savings and lower borrowing rates or in the form of loyalty incentives schemes) are returned directly to customers, as opposed to shareholders, who may or may not be customers. In 1998 two independent surveys of the mortgage market, one by The Research Department and one by Moneyfacts, found that building societies offered the most competitive loans over both one and three years. Similar results were reached by both in finding that, of the 30 largest lenders in the UK, nine of the ten cheapest were mutual building societies, and nine of the ten most expensive lenders were banks.[19] Survey results published in the March 1999 edition of *What Mortgage?* show that, of 73 lenders, the cheapest 30 over a 10 year period were all building societies.[20] It has also been argued that the converted building societies are the ones offering some of the least attractive rates (see Simon, 2000).

More generally, there is evidence that demutualisation exacerbates the problem of financial exclusion which arises from financial institutions merging and then rationalising their branch structures, or simply closing down branches in less profitable communities (see Conaty and Mayo, 1999, and Leyshon and Thrift, 1996). A BSA sponsored research project at the University of Newcastle found that societies that had not demutualised were opening more branches, whereas societies which had chosen the conversion route were closing branches.[21] Abbey National, the first of the building societies to convert, cut by several hundred the number of community branches (small sub-branches) between 1989 and 1996. Following its takeover of National & Provincial Building Society in 1995, it also planned to close N&P's 200 community branches (Davidmann, 1996). The 1999 KPMG annual survey found that there was a net loss of just over 1% of building societies' networks. Since this was far below the loss of networks by commercial banks, and in light of the potential for remote distribution that electronic technologies make available, it was considered to be 'a consequence of societies seeking to demonstrate mutuality by keeping branches open to serve local members' (KPMG, 1999).

Since the demutualisation wave, credit unions have begun to fill the gap in financial services provision where building society conversions and the associated withdrawal of community branch structures have left poorer communities and socio-economic groups under-serviced.[22] McKillop and Ferguson (1998) show that credit unions are (weakly) biased towards the interests of borrowers. They argue that, given the important role that credit unions play in extending credit to members of low-income communities, this bias is socially optimal, and that existing dividend and loan rate ceilings imposed on credit unions should remain in place. On this basis, credit unions would appear to have a comparative advantage in overcoming moral hazard and adverse selection problems in providing small loans to individuals who would otherwise not have access to credit. However, this sector is still small in terms of total assets (amounting to £124 in 1998 (Amess and Howcroft, 2001: 60)) and the demise of building societies will leave under-serviced many looking for stable, low interest mortgages.

4.3 Potential efficiency gains: access to capital; diversification of functions and services

What of the efficiency gains from conversion? Easier access to capital markets was part of the justification for conversion given by the Halifax, Alliance and Leicester, Northern Rock, and Woolwich building societies. On this basis, building societies require access to capital in order to grow or in order to support existing operations in changed market conditions. Conversion provides access to equity capital, whereas building societies' capital sources are limited to retained profits and subordinated debt.

This argument would have greater force if converting societies had weak capital bases at the time of conversion, and if they used conversion to build up their reserves. The opposite seems to be the case. A 1999 analysts' report by Thompson Financial Watch noted that converting building societies were found to have stronger capital bases than non-converting societies, and found limited evidence that demutualised building societies were taking advantage of the access to capital afforded by investor-owned status. Rather than accessing the capital markets, all of the demutualised societies had been aiming to *reduce* capital ratios following conversion.[23]

Societies seeking access to capital do, in practice, have other options open to them. It is possible (and lawful) for them to leverage their substantial reserves to issue subordinated debt if, indeed, they require access to capital, and many have done so over the past few years. The Nationwide, currently the largest building society, is among several to have issued debt in the form of 'PIBS' (preference interest-bearing securities). Other options open to building societies include raising profitability for growth through off-balance-sheet business and income derived from services, which do not require additional capital; securitising existing assets; and diversifying through agency arrangements rather than through growth (Llewellyn and Holmes, 1991).

It is also possible that the flow of new equity capital to newly demutualised financial services firms would be limited. Excess capacity in globalised banking markets, caused by a rise in the number of investor-owned banking institutions and competitive pressures from new entrants in deregulated markets, point in this direction. This is why there was a debate at the time of the proposed demutualisation of Bradford and Bingley Building Society, on whether a stock market flotation would deliver the returns anticipated. With poor institutional investor interest and shrinking market valuations for banks, there was speculation that the Bradford and Bingley would choose to convert via a trade sale instead.[24]

US evidence on conversions among mutual life insurers likewise suggests that demutualisations are not motivated by the need to access capital. Mutuals with strong reserves are more rather than less likely to convert, precisely because they offer better opportunities for wealth transfer to prospective shareholders. In a sample of US life insurers it was found that the level of free cash flow was positively associated with the likelihood of demutualisation and that demutualising insurers had significantly higher ratios of surplus to assets than other mutuals (Carson et al., 1999).

Another argument frequently put during the recent wave of demutualisations was that the legislation under which building societies operate disadvantages them relative to investor-owned banks by placing greater restrictions on the range of activities that they can undertake. As we have seen, legislation from the mid-1980s has gradually eased the conditions attaching to the commercial activities of building societies. The range of areas into which building societies have diversified was discussed in the BSA's comments on the UK Banking Services Review Consultation Document, published 25 January 1999:

> 'A number of societies are able to offer independent financial advice on products regulated under the Financial Services Act and two societies have life insurance subsidiaries. A number of societies offer money transmission accounts (although not all offer overdraft facilities) and credit cards, while others operate estate agency and stockbroking subsidiaries. For some societies these activities comprise a substantial part of their business; for

> the sector as a whole, however, they are much less important than the mainstream mortgage and savings activities.'[25]

It has nevertheless been suggested that 'building society restrictions demonstrate a lack of competitive neutrality *vis-à-vis* banks and limit the opportunity for diversification and risk reduction, e.g. the still heavy reliance upon the housing market which may tend to reduce safety and stability' (Jarman, 1999). Surveys of building societies' attitudes towards regulation suggest that larger building societies do perceive a restraint, in particular with respect to the extent to which they can diversify their assets (ibid.). Whether this is an inherent problem is not clear. The presence of a legislative constraint is, as we have seen, an inherent part of the 'mutuality contract' with its attendant incentive effects. It seems that smaller societies appear to accept the statutory 'straightjacket' more readily. It can be argued that the lifting of certain legislative restrictions would be preferable to conversion as a means of overcoming the supposed negative effects of the overdependence of building societies on a small range of products.

4.4 Accountability, control and performance: theory and evidence

At the heart of the argument for conversion is the claim that investor-owned status provides a stricter performance focus and clearer lines of accountability and a more efficient solution to the problem of divergence of interests among classes of claimants (Hird, 1996). According to this point of view, demutualisation is seen to promise improved corporate governance via stricter stock market discipline; greater clarity of ownership rights; incentives for shareholder activism through concentrated holdings and the one share, one vote system of shareholder control; and potential for higher-powered managerial incentive structures through share and share-option grants.

In principle, such a claim goes against the suggestion that a diversity of corporate forms, offering different solutions to the trade-off between internal and external governance costs identified by Hansmann (1996), is preferable to a one-size-fits-all approach in which the shareholder-owned enterprise crowds out other forms. There is, moreover, a substantial body of empirical evidence to support the argument that shareholder-owned companies and mutuals serve different purposes, take different attitudes to risk, and so offer alternative combinations of risk and return in such a way as to promote customer choice.

4.4.1 Board governance

One aspect of this is the internal control environment, particularly board monitoring and control and the use of incentives. Mayers et al. (1997) examine board composition of US mutual life insurance companies. They point out ways in which the inalienability of ownership rights of mutual policyholders places constraints on the 'corporate control technology' available to them as owners and argue that this places greater emphasis on the use of outside board members in mutuals. Their findings support this proposition. They find that, for a sample of 120 mutual and 225 commercial life insurance companies in the US, the boards of mutuals had larger proportions of outside directors than the boards of commercial insurance companies. They also find that there was greater use of outside board members by mutuals which had recently converted from commercial form, than among similar companies in the commercial sector. In addition, provisions relating to outside director representation were more demanding for mutuals than for listed companies, reflecting a greater emphasis on the role of outside directors on mutuals' boards. There was evidence of increased control by outside directors on policyholders' behalf, in that, where mutuals had greater outside director representation, there were lower costs related to managerial value extraction (usually reflected in measures related to salary, wages and rent). However, for listed companies the number of outsiders has no discernible effect on the magnitude of these expenditures. Therefore, where other control mechanisms are not available to mutuals as a result of their inherent ownership structure, there is evidence that available controls are leveraged to achieve a comparable control environment to that of listed companies. These include a higher proportion of non-executives on boards of directors, greater use of board committees, and greater likelihood of having a remuneration committee (O'Sullivan and Diacon, 1996).

Incentive structures for both listed company and building society executive management include a basic salary and benefits, as well as an incentive component. The incentive component for executives of the Nationwide, the largest UK building society, has an annual bonus scheme, which is determined on the basis of performance-related criteria, and a medium term incentive plan, which takes a three year approach to the evaluation of business success. Four performance measures comprise the bonus plan: member satisfaction, efficiency, profits sufficient to sustain capital ratios, and personal performance.[26] The typical listed company also incentivises its management with an annual bonus scheme, usually paid out in cash, and a longer term incentive scheme based on performance over (usually) three years, paid out in (usually) in both cash and shares. Option grants may be made as part of, or in addition to this longer-term incentive scheme. Rarely is any reference made in the remuneration reports of listed companies to non-financial performance criteria involving employee or customer satisfaction.

Another key difference between mutual and listed company executive compensation is the lack of an incentive mechanism equivalent to stock grants or stock options (due to the absence of a market in tradeable ownership rights). Managerial share ownership is seen to reduce agency costs by having 'managers bear the full impact of their decisions on their personal wealth',[27] thereby aligning their incentives more closely with the financial interests of shareholders. The granting of share options has been seen to provide the opportunity to present management with even more highly powered incentives than share grants. However, the research evidence on the link between director pay and company performance in public listed companies remains inconclusive – especially with respect to the use of share-based compensation – and indignation at the size and growth rate of executive salaries persists in the press in both the UK and the US (where the use of share-based compensation is even higher). A recent survey of executive remuneration showed that, the market downturn notwithstanding, executive pay was up 8% on last year's figures for FTSE-100 companies, whereas the average employee salary only increased by 3 or 4%.[28]

What is clear is that, at an average of £600,000 per executive director in direct payments (payments before long-term incentive plan or stock option awards are calculated) (Cook and Leissle, 2000), executive director payments represent a not insignificant cost to public companies. This is a cost that, for whatever reason, appears to have been contained to a greater extent in the building societies sector. According to Bob Goodall of Save Our Building Societies, a director of Bradford & Bingley saw his salary rise from £87,698 in 1999, prior to conversion, to £221,530 in 2000 following it.[29]

4.4.2 The market for corporate control

As we have seen, the ability of mutuals' members to redeem their claims on demand at a price set according to a pre-specified rule, means that there is no secondary market for ownership claims in mutuals. Therefore there is no price mechanism through which the present value of the ownership claim, incorporating the 'implications of internal decisions for current and future net cash flows', can be signalled, and there is also no medium through which ownership transfers can take place (Fama and Jensen, 1983a; Thompson, 1997).

In comparing the external disciplinary pressures on mutuals' and listed companies' top management it is important, however, to bear in mind that there are other external disciplinary pressures which might substitute for an active market for corporate control in the building societies sector. One possibility is that control operates through external product market competition. In this vein, Llewellyn and Holmes (1991 and 1997) argue that competition among financial services firms - which, for building societies, has increased in both key markets (retail deposits and mortgages) dramatically since the beginning of the 1980s - has placed considerable pressure on building societies to improve efficiency (see also Drake, 1995). This pressure, they argue, has had a more substantial disciplining influence on building society management than pressures which the stock market is able to exert on listed companies.

Inefficient managerial behaviour can cause depositors to withdraw their funds. Fama and Jensen (1983a,b) argue that the absence of external stock market control is offset by members' rights to withdraw funds from mutuals quickly and at little expense. This imposes on mutuals' management a discipline comparable to the market for corporate control in that 'exit' reduces the amount of assets that management control. Moreover, it may be argued that the use of exit provides a more powerful control over the management of mutuals than in the case of listed companies, in that the sale of an equity stake does not have the same direct effect on the amount of assets under management control in the case of a listed company, even if the share price should fall (Drake, 1997).

As we have seen, the Building Societies Acts provide for the equivalent of mergers in the building societies sector, through a transfer of a society's business to another society or to an investor-owned company. In addition, mergers or acquisitions have sometimes taken place at the encouragement of the regulator. Where the viability of a building society is threatened, the regulator will be concerned to maintain the confidence of the public in the building societies sector and therefore encourage the takeover of the ailing building society by a viable society. In the case of a very small ailing building society, relative to the acquirer, the usual requirement for member-consent may be waived (Ingham and Wong, 1994).

These remedial interventions by the regulator may function in some ways as would the disciplining effects of the threat of takeover in the case of under-performing management in the investor-owned sector. Thompson (1997) notes that, despite the absence of hostile takeovers among building societies, there has nonetheless been a large amount of merger and acquisition activity in this sector. For instance, between April 1981 and April 1993, 115 out of 200 societies disappeared through intra-sector mergers. He identifies three testable hypotheses for explaining the observed merger activity in the building societies sector. The first two, the pursuit of synergies and the functioning of the market for corporate control, comprise the 'natural selection' process. The third encompasses merger and acquisition activity aimed at delivering size and growth, that is, fulfilling managerialist objectives. Thompson found that any society posting a loss had a greatly increased probability of being acquired and societies with reserves above the minimum level had a reduced probability of being acquired. This activity appeared to have been prompted by the regulator and partially substituted for a stock market-driven market for corporate control.

4.4.3 'Common bond' and governance

Amess and Howcroft (2001) argue that the higher level of trust and co-operation that prevails in mutuals, particularly small mutuals like credit unions, as opposed to shareholder-owned financial institutions, facilitates implicit contracting. This gives them a comparative advantage in economizing on transaction costs of governance and more efficiently solving problems associated with adverse selection and moral hazard. The Credit Union Act 1979 imposes a 'common bond' requirement to the effect that membership be based on occupation, residential or employment locality, employer, club or other organisational membership. Beyond its legal form, the 'common bond' can be thought of as a social psychological construct. The threat to the continued role of mutuality in the British economy and in British society has given impetus to a resurgence in the support for mutuality, with the emergence of pro-mutual groups such as Save Our Building Societies and Mutuo.[30] This commitment to mutuality is itself a form of 'common bond', which surviving building society members, especially members of regional building societies, may experience. The requirement of some building societies that new members sign away benefits from conversion to charities, which is seen to screen out carpetbaggers from those genuinely interested in building society membership, can likewise be seen as restoring the ‘common bond’ between new and incumbent members.[31]

4.4.4 Direct performance comparisons of mutuals and investor-owned banks

Further evidence is available from studies examining the efficiency and profitability of mutuals relative to listed companies providing similar services, such as mortgage finance and personal savings services. Efficiency and profitability measures are often used as proxy measures for managerial performance, or as indicators of the relative size of underlying agency problems. Drake (1997) charts cost to income and return on capital ratios for UK building societies and commercial banks. These show that building societies have tended to operate with greater efficiency, showing much lower cost to income ratios over the period 1970-1994, and with higher and less volatile profitability. These efficiencies may be used to bolster building society reserves or can be redistributed to members via improved rates. Valnek (1999) derives empirical evidence for the period 1983 to 1993 showing that UK building societies had significantly higher returns on assets, whether or not measures were risk-adjusted, as well as higher net income than investor-owned banks. Since the mid-1990s these performance advantages appear to have been translated into superior savings and borrowing rates offered by building societies to their members.

The economic literature also supports the suggestion that financial mutuals gain competitive advantage from being better able to address agency or governance problems arising from heterogeneity of interests than is the case with investor-owned companies. Mayers and Smith (1988) argue that the longer the term of the contractual relationship between the mutual and its members (they focus on insurance mutuals), the larger the incentives would be for external shareholders to expropriate rents from depositors /mortgage holders/policy holders. Therefore, combining the ownership and debtholding functions removes costly conflicts of interest between policyholders and owners in the case of mutual insurance companies. Hart and Moore (1998) also develop a case for arguing that mutuals' efficiency advantage is contingent on them having a more homogeneous clientele than investor-owned banks (based on efficiency analyses of stock exchange movements). From this Valnek (1999: 929) extrapolates that 'as small retail and large corporate customers most probably have different preferences, [mutuals] avoid costs related to conflicts between different groups of a heterogeneous clientele.'

As we have seen, in mutual building societies, as opposed to investor-owned retail banks, the functions of owner (shareholder) and customer (depositors and borrowers) are combined. In addition, the clientele is comparatively homogeneous, in that building societies are restricted to some extent to the activities of accepting retail deposits and engaging in home mortgage lending, whereas banks' customers consist of individuals as well as corporate customers. In the case of commercial retail banks, shareholders' interests diverge from those of policyholders, mortgage holders or depositors. Hence Drake (1997:7) notes that:

> 'equity shareholders may prefer a higher risk profile for the institution than would depositors due to the former's limited liability. This implies that shareholders can benefit from potentially significant "upside gains" while being exposed to only limited downside potential. In contrast, depositors do not share this upside potential and would implicitly be subject to greater risk given the limited scope of deposit insurance. Clearly, in financial mutuals this particular aspect of the agency problem is absent as owners and customers are one and the same.'

Life insurance and mortgage provision also involve long-term contracting with members, in contrast to equity investments which typically involve short-term 'spot' transactions. Those with longer-term contracts are more vulnerable to exploitation by those with shorter-term interests in the organisation:

> 'The owner-policyholder conflict is likely to be relatively high in the stock ownership form because stockholders have an incentive to expropriate value from policyholders [or mortgage holders] by taking actions such as changing the risk-characteristics of the firm after policies have been issued.' (Cummins, Weiss and Zi, 1999: 1255)

While financial mutuals may avoid some of these costs, it could be suggested that the absence of a clear shareholder value norm insulates building society managers from pressures to limit 'expense-preference behaviour'. This refers to the extent to which managers spend unnecessarily on things that they prefer, but which are not necessarily value-enhancing, such as excessive salaries, additional staff, and other perks (Drake, 1995). The evidence here is equivocal. Cummins, Weiss and Zi (1999) find evidence from the US property liability insurance industry, derived from the period 1980-1991, indicating that mutuals and investor-owned companies operate on different production and cost frontiers. This means that each employs a different technology (broadly defined as encompassing both the contractual arrangements and the physical technologies). They found that investor-owned companies were better than mutuals at producing the outputs that investor-owned companies would normally produce (that is, operating in more complex and heterogenous lines of business) and that mutuals were more efficient at producing outputs typical of mutuals. However, within their respective areas of operation, investor-owned companies appeared to have a comparative advantage over mutuals at controlling costs, which the researchers take as indicating a greater potential for expense-preference behaviour among mutuals' management than among investor-owned companies, and, therefore, higher costs associated with managerial opportunism.

Valnek (1999) finds that, where mutuals and commercial retail banks engage in activities of similar riskiness (indicated by identical standard deviations on their returns on assets), banks appear to suffer higher costs from the downside outcomes of risk and make higher loan loss reserve provisions, which reflect a greater propensity for risk-taking among managers of banks, and the consequent riskier nature of undertakings by banks, as compared to mutuals. One possible explanation is that managers of banks probably hold shares in their firms and therefore stand to gain from risky decisions. Managers of mutuals, on the other hand, can only lose their perks by taking risky decisions which might bankrupt the organisation. Risk-averse depositors will realise this and choose to bank with mutuals over commercial banks. Thus self-selection of clientele takes place.

4.5 Preserving a plurality of forms in financial services provision

Attempts to understand the coexistence of mutuals and investor-owned companies in particular sectors of the financial services industry (most focus on the US life and property insurance industry, although findings are considered to be generalisable) address agency-theory propositions regarding owner-manager incentive conflicts and owner-policyholder/mortgage holder conflicts of interest. These hypotheses predict that listed companies are best suited to solving the former but that the mutual form solves the latter. From these propositions have been derived various hypotheses regarding the market areas and types of business operations that each is best suited to. In general terms, it is suggested that listed companies will be most prevalent in activities that involve significant managerial discretion, and that mutuals will be most prevalent in lines of business requiring long-term contracting (see Pottier and Summer, 1997).

A number of studies have found that, where listed companies and mutuals are represented in the same sectors, listed companies are generally associated with riskier activities, spread over greater geographic areas. Mutuals tend to be more prevalent in activities involving longer-term contracting and showing lower risk. Managerial incentives and self-selection of clientele may constitute part of the explanation, in line with Rasmusen (1988).

A number of arguments, based on propositions derived from inherent differences between mutuals and listed companies, have been put forward to explain why mutuals can be expected to be involved in less risky activities (see, for instance, Fama and Jensen, 1983b, and Smith and Stutzer, 1995). Smith and Stutzer (1995) develop a model which explains the coexistence of mutuals and investor-owned companies in the insurance industry by arguing that mutuals are better suited to addressing problems of *moral hazard* arising out of information asymmetries. In the case of participating insurance contracts (sold mainly by mutuals), the insured shares in the overall operating risk of the insurance company, whereas in the case of non-participating insurance contracts, the price of insurance is set beforehand. This will lead to an outcome where high-risk insurance consumers will purchase non-participating policies (sold mainly by investor-owned insurance providers) and low-risk consumers will purchase participating policies (Smith and Stutzer, 1990).

Lamm-Tennant and Starks (1993) provide empirical evidence on the relationship between organisational form and the risk of activities undertaken. They confirm that, overall, investor-owned companies have higher total risk than mutuals. In particular, they find that activities in more riskier lines of business are most likely to be offered by investor-owned companies, investor-owned companies are more likely to be prevalent in geographic areas with higher risk, and investor-owned companies sell policies in more lines of business.

Born et al. (1995) focus on companies in the US property-casualty industry to investigate the extent to which their prevalence in various lines is related to their particular approach to agency problems. They found that investor-owned companies generally serve broader geographical areas and write more lines of insurance than mutuals. This observation is consistent with arguments that mutuals are better suited to operating in only a narrow range of operations and over a limited geographic area. Secondly, investor-owned companies appeared to respond to reduced profitability in particular markets by cutting back business operations more rapidly than mutuals and expanding operations in profitable areas more rapidly. This might reflect the potential for opportunism where the interests of shareholders and policyholders may differ. Thirdly, they found that, for a given amount of premiums, investor-owned companies have higher losses than mutuals. This is taken to indicate that mutuals are better at screening or at attracting less risky business than investor-owned companies.

Similarly, Cummins, Weiss and Zi (1999) present empirical evidence showing that mutuals are best suited to lines of business involving less managerial discretion but longer contractual time horizons, whereas investor-owned companies are best suited to lines where managers are required to exercise a relatively greater amount of discretion in business decisions and in operating over larger geographical areas. The former's technical advantage is considered to lie in its ability to deal effectively with the owner-policyholder conflict, whereas the latter is considered to have an advantage in solving the owner-manager conflict.

5. Conclusions

This paper has reviewed the substantial empirical evidence relating to the comparative properties, in terms of corporate governance, of mutuals and investor-owned companies. The evidence supports the suggestion that mutuals and investor-owned companies provide distinct solutions to the problems which are inherent in corporate governance. The extent to which costs associated with one type of governance arrangement outweigh those associated with the other type will therefore determine which form is most prevalent in particular types of commercial activities. Empirical evidence suggests that, as theory implies, investor-owned companies make higher returns for investors and undertake riskier business ventures than mutuals do. Conversely, the mutual form is more appropriate, in principle, for dealing with long-term, incomplete contracts of the kind required by personal borrowers seeking a low-risk loan for the purposes of house purchase and savers seeking a low-risk form of saving.

There is therefore empirical support for the claim that the legal and institutional framework should encourage the preservation of diversity within the financial sector as a whole. Inefficiencies would result, from a governance perspective, should financial mutuals begin to disappear as a result of conversion to investor-owned status. Such a move is not easily reversed. The Ecology Building Society is the only building society to have been created in recent years. It was set up in 1981 and is dedicated to building projects which follow ecological principles. Llewellyn and Holmes (1991:321) argue 'there is virtually no possibility of [listed companies] converting to mutual status and few new mutuals are being formed. It is difficult to reverse demutualisation.' Leadbeater and Christie (1999:59) likewise note that '[r]egulatory requirements designed to ensure lenders have a healthy balance sheet make it virtually impossible to create a new building society from scratch.' Once the accumulated surplus from generations of organisation is dissipated, it cannot be quickly restored.

How, then, is it possible that the building society sector should have shrunk as it has in the wake of the deregulatory changes made by the 1986 Act? The answer lies in a close analysis of this variant of the mutual form as it developed during the nineteenth and twentieth centuries. The 'permanent' building society form was a highly successful institutional innovation which married the needs of homebuyers for low-cost loans with those of investors in search of a low-risk form of saving. The inherent divergencies of interests between investors and borrowers was solved by severely restricting the property rights of both groups, to the extent that their claim to be the residual owners of the income stream generated by the organisation was highly attenuated, at best.

The gradual mutation of the original customer-owned form (the terminating society) into a type of non-profit enterprise within which managers acted as fiduciaries for successive generations of borrowers (the permanent form) created problems of its own. In the 1950s, building societies grew rapidly in a period when they were protected against effective competition both from the commercial retail banks and from each other; again, in the early 1990s, societies accumulated large reserves which attracted the interest of speculative investors. Meanwhile, active member participation in the affairs of societies dwindled, in particular as societies grew larger through amalgamation.[32]

Against this background, the introduction of competition in the retail banking and mortgage market at the same time as changes to corporate governance made conversion possible acted as a major external shock. By facilitating conversion without putting effective safeguards in place against opportunistic entry by investors intent only on netting a windfall gain, the 1986 Act altered the environment in such a way as to make it likely that building societies would come under considerable pressure for demutualisation. The hybrid form which emerged after the *Abbey National* judgment in 1989 was inherently unstable, and its unravelling was inevitable. But it is possible that no safeguards could have been effective once the possibility of realising the surplus via conversion was in place.

The institutional guarantor of the mutuality contract was the much (and unfairly) maligned 'legislative straightjacket'. Without this in place, the task of maintaining a coalition to defend mutual status was inherently problematic. The use of charitable assignments and other devices to fend off 'carpetbaggers' was an evolutionary response from the supporters of mutuality within building societies which may, to some extent, have succeeded. However, without some attempt to arrive at a new legislative solution to protect mutual status from predation of this sort, it cannot be said that the future of the remaining building societies is ensured. Regulatory intervention will be required to for these societies to be able to credibly commit to the principles of mutuality in the long term, protecting the confidence and trust of existing and potential members.

The recent history of the British building society sector therefore demonstrates the dangers of assuming that the evolution of organisations reflects a process of convergence on efficient forms. The path of change is shaped by contingent events and by shifts in the institutional environment which are sparked of by the legislative process (Roe, 1994). Deregulation which brings about changes in property rights can have unanticipated, destabilising effects on corporate governance. Supporters of the Building Societies Act 1986 apparently did not anticipate that it would lead to a shrinking of the mutual sector. The Act put in place statutory protections to guard against the very divergencies of interest between managers and investors, on the one hand, and borrowers, on the other, which later proved to be the catalyst for demutualisation. To understand better the processes involved, a focus on the role of collective actors in pushing for legislative and judicial rearrangements of property rights is called for.

Notes

1 Hansmann (1996: 12) uses the term 'patrons' to refer to 'all persons who transact with a firm either as purchasers of the firm's products or as seller to the firm of supplies, labour or other factors of production; here we adopt the more generally used term 'stakeholder' to refer to those who transact regularly with the firm in such a way as to give rise to issue of relation-specific investment and contractual incompleteness (see Zingales, 1998).

2 Current Legal Statutes note to the Building Societies Act 1986, at p. 15.

3 Treasury Select Committee - Ninth Treasury Report (1999): http://www.parliament.the-stationery-office.co.uk/pa/cm199899/cmselect/cmtreasy/605/60502.htm.

4 Building Societies Act 1997, s. 1(3), amending Building Societies Act 1986, s. 5(5).

5 Building Societies Act 1997, s. 1(1), amending Building Societies Act 1986, s. 5(1).

6 BSA, 2000 - website; Leadbeater and Christie (1999); Marshall et al. (1997).

7 By 1999 there were 68 building societies accounting for 18% of the stock of UK personal savings, 25% of the stock of UK residential mortgage loans to individuals (down from 80% in 1994), and a 40% share of new net lending over the period 1997 up to March 1999. The sector was still important in terms of size - by the end of 1997 these building societies accounted for 2.8 million borrowers and 19 million investors; and employed 37,309 people. See Leadbetter and Christie, 1997; Treasury Select Committee - Ninth Treasury Report (1999).

[8] Current Law Statutes annotation, at p. 203.

[9] *Abbey National Building Society* v. *Building Societies Commission*, 9 January 1989. The judgment is not reported in the law reports, but is reproduced in the *Annual Report* of the Building Societies Commission for 1988-89, at pp. 53- 59.

[10] Current Law Statute annotation, at p. 196.

[11] Para. 2.

[12] Building Societies Act 1997, s. 25, inserting new para. 20A in Building Societies Act 1986, Sched. 2.

[13] Mike Blackburn, quoted in Clarke (1998:100).

[14] See, for example, Brown-Humes (1999d); Brown-Humes (1999b) and Calder (2000).

[15] See B.S. News, May (1999), http://www.bsa.org.uk/BSNews/bsnMay99.html.

[16] "Carpetbagger launches latest campaign", *Guardian*, March 17 2001.

[17] Treasury Select Committee - Ninth Report (1999).

[18] Overviewed in the BSA response to UK Banking Services Review consultation paper (1999) at: http://www.bankreview.org.uk/responses.html.

[19] BSA response to Banking Services Review consultation paper (1999).

[20] 'Mutual Loathing', *Sunday Telegraph*, 23 January (2000).

[21] Treasury Select Committee - Ninth Treasury Report (1999).

[22] By 1998 the number of credit unions in the UK had grown to 624 (Amess and Howcroft, 2001:60).

[23] Thompson Financial Bank Watch (1999), in 'The Future of UK Building Societies'; summary of results in BSNews, May (1999), http://www.bsa.org.uk/BSNews/bsnMay99.html.

[24] Reuters News Service (2000), 'B&B may opt for trade sale instead of IPO - paper', Reuters Press Digests, 12 March.

[25] BSA response to Banking Services Review consultation paper (1999).

[26] See the remuneration report for Nationwide Building Society at: http://www.nationwide.co.uk/newsinformation/results/report.ht m

[27] Valnek (1999), referring to the argument first made by Jensen and Meckling (1976).

[28] Brewis, J. 'Salaries of top FTSE executives continue to rise', *eFinancial News*, 8 May 2001

[29] Harvey, A. 'Pro-mutual group on the warpath', *The Scotsman*, 17 April 2001.

[30] See: Harvey, A. "Pro-mutual group on the warpath", *The Scotsman*, 17 April, 2001; and Guthrie, J. "New breed of fans found in football and the utilities", *Financial Times*, 4 May 2001.

[31] Since November 1997, the Nationwide Society has required new members to agree to assign any windfall to charity but has nevertheless attracted more than 2m new customers over the

period. (Jenkins, P. 'Nationwide rejects vote on conversion building society decision angers carpetbaggers', *Financial Times*, Apr 21, 2001.)

32 This is in contrast to patterns of active participation which, in varying degrees, characterise continental European forms of mutuality: see Cook, Deakin and Hughes, 2001: ch. 6.

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